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on

The State of the Airline Industry

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Chairman Shelby, Ranking Member Murray, and Members of the Committee, I appreciate the opportunity to appear before the Committee to discuss the state of the airline industry.

As you are well aware, these are extraordinary times for our airline industry. Significant developments are occurring virtually every day, some that intensify ongoing concerns about the industry's continuing financial viability, and others that show promise that the industry is beginning to come to grips with problems only it can resolve. The Administration is working hard to keep up with these developments and to assess their near-term and longer-term implications.

Almost three months ago, on January 9, in testimony before the Senate Committee on Commerce, Science, and Transportation about the future of the airline industry, I pointed to record losses during calendar year 2001, continuing heavy losses during the first three quarters of 2002, and the likelihood of still more heavy losses during the last quarter of 2002 and into 2003. A major concern presented by that information was that after an element of recovery in the early part of 2002, the recovery appeared to have stalled.

We now know that the predictions for large losses during the last quarter of 2002 were correct, and Wall Street analysts, even before the war with Iraq, had changed their loss predictions for 2003 from the range of $2.5 to $3.0 billion to about $6.5 billion. The large network airlines that today account for a major part of our domestic passenger air transportation system account for most of these losses, and their cumulative losses for three years, even in the absence of the war with Iraq, would accounte for more than one-third of their annual passenger revenue. Of course, the war with Iraq will both reduce their revenue and increase their losses in 2003.

In my testimony three months ago I also pointed to the fact that the airline industry has proven to be remarkably resilient over the years, and that not all news was bad. Despite the overall heavy losses for the industry, and in stark contrast to the experience of the large network airlines, a cadre of low-fare airlines had remained profitable and was rapidly expanding. This trend has continued as well.

In addition, we now see individual airlines making progress in getting their costs under control. US Airways has emerged from bankruptcy in part because it has been successful in restructuring its costs, both through restructuring its labor costs, and from overhauling its basic business plan. Other large network carriers have also progressed with their cost control efforts, although it remains to be seen whether these gains will allow still more carriers to emerge from bankruptcy and others to avoid the bankruptcy process.

Many issues are now at play--structural issues that emerged before September 11, the aftermath of the September 11 terrorist attacks, the sluggishness of the return of airline demand, and now the war with Iraq. How all of this is resolved will have major consequences for the airline industry and related industries, and, indeed, our economy for many years to come.

To provide context, before getting into more specific details about what is driving the financial plight of much of the industry, an important deregulation development must be briefly discussed. Specifically, two very different types of carriers have evolved – large network carriers and low-cost carriers. Generally speaking the former are pre-deregulation carriers and the latter are new airlines that evolved after deregulation. To a great extent these two types of airlines serve different types of markets, have different business strategies, and focus on different customers, even when they operate in the same geographic regions.

A basic reason for the emergence of the low-fare airlines is that this was the only effective response to the powerful networks that were quickly built by the pre-deregulation airlines. Low costs allowed the new carriers to charge such low fares that they could profitably serve a demand sector that was mostly unserved by the large network airlines. While these airlines, other than Southwest, struggled for years to establish a competitive toehold, several have now done so. Almost ironically, while the low-cost strategy was initially pursued as a vehicle for coexisting with the larger, dominant network airlines, the success of this strategy now poses a serious threat to the continuing viability of the larger airlines unless they too are successful is their own efforts to control costs.

But both types of operation are vital components of our nation’s air transportation system. Low-cost airlines are an increasingly important element of our commercial air travel system. Their substantially lower costs enable them to provide capacity for price sensitive passengers, and to price compete for time sensitive passengers who are otherwise faced with substantially higher prices. But the traditional “major” airlines, though their feeder systems, serve an unmatched variety of markets – including a great many smaller communities that would not be on the aviation map without them. Over the course of many decades our largest airlines have established critical international franchises as well – links to foreign markets that are essential to trade and economic growth.

The simple truth is that this country needs the diversity of airlines that we enjoy in the market today, and any suggestion that we can do with just one category or the other is silly. That is why we cannot be cavalier about any part of the industry, and why the Administration is watching developments so closely.

With this background I will now briefly walk you through the various changes and events that have contributed to the problem facing our major airlines today by directing your attention to a series of graphs and tables. The first graph shows why a long period of record profits for the airline industry abruptly came to an end well before the September 11 terrorist attacks. This graph shows trends both in unit revenues, or operating revenues per available seat mile, known as RASM, and in unit costs, or operating expenses per available seat mile, known CASM. Note that for several years CASM increased very slightly, compared with much larger increases in RASM. These trends portray a period of solid revenue growth and cost control underpinning continual profitable operations, indeed several years of record profits. But the combination of increasing costs beginning in 1999, and declining demand starting in early 2001, turned record profits into losses. Indeed, the decline in industry profitability for the year ended June 30, 2001, compared with a year earlier, was the largest year-over-year decline ever, before September 11. The losses for the year ended June 30, 2001 were not record losses, but that too changed abruptly with the terrorist attacks.

The table that you now see shows operating profits or losses by quarter for the last three calendar years for the large network carriers, and a number of other airlines including a group of low-cost carriers that account for over 90 percent of the passenger industry. Note first, that these carriers collectively have sustained operating losses approaching $10 billion for each of the past two years. Observe, however, that the group of low-fare carriers has continued to earn profits during this same time, and that this is not just attributable to Southwest. Five of the six low-fare carriers earned profits in 2001, and half of them earned profits in 2002, while two of the other three were close to break even. Note next, that the last profitable quarter for the large network carriers was the third quarter of 2001, and also, these carriers continued to suffer sizeable losses throughout 2002. It is especially important to note that these carriers' losses have accelerated since the second quarter, including the third quarter that is normally their best quarter of the year. In other words, after what appeared to be the beginnings of a recovery for these airlines, the recovery clearly has stalled. Despite the disastrous losses during the last two quarters of 2001, total losses for calendar 2002 approach the same levels. Indeed, in reality 2002 losses are even greater given that these six large network carriers' operations were considerably smaller.

You will see on the next graph that the negative operating margins of the large network carriers were even greater in 2002 than a year earlier. Note also that this varies greatly from carrier to carrier. During 2001, almost one out of every $5 collected by American and one out of every four for United were lost. You can also see that during the first three quarters in 2002 for which we have final results these tendencies do not change much for either carrier. Finally on this table, note that in contrast to the double-digit negative operating margins for the large network airlines, the low fare carriers earned very respectable positive operating margins. Indeed, the margins for these carriers in 2001 exceeded those for the network carriers for 2000.

In addition to the financial information the airlines file with the Department every quarter, they also file preliminary data on a monthly basis. While this information is subject to change, we believe it can be relied upon to reveal general tendencies. Our review of this information suggests that the financial trends you have just in the quarterly data throughout 2002 are continuing into 2003. Indeed, the results for the large network carriers in January 2003, or 16 months after the September 11 terrorist attacks, are no better than a year earlier.

With this context, please look at the next graph. This compares *weekly* traffic, in terms of revenue passenger miles, for the six largest network airlines plus America West, beginning for the week ended December 15, 2002 with traffic a year earlier. This shows that from mid December 2002, to the end of January 2003, traffic was up slightly over a year earlier. Then note the rather marked downward trends beginning with early February. The start of the downward slide coincides with changing the national security code to Code Orange in early February, suggesting considerable sensitivity to possible terrorist attacks. Next, note the increased rate of decline at the time of the first strikes in the war. This information is presented by the four major operating entities, and, as would be expected, the transatlantic entity has suffered the greatest decline.

The next chart compares *daily* traffic for the same carriers beginning March 12, 2003 with traffic a year earlier. Initially the trend is up slightly until the Azores Summit, perhaps recovering somewhat from the previous Code Orange. Traffic then plummets after the 48-hour ultimatum, and again as the war starts. Note that by March 26, traffic for each entity is down from about 20 to 25 percent for each operating entity. These trends are illustrated on the next graph on a system-wide basis.

The last graph shows declines in load factor points on a daily basis since March 12, 2003. Although the carriers have cut capacity during this time, those cuts have not kept pace with traffic declines, and the result is large reductions in load factor.

So where does this leave us? Many airlines, including the large network airlines that now provide the bulk of airline service in the U.S, have consistently suffered large losses for more than two years, they are heavily leveraged as a result, and now, once again, they see airline demand in steep decline for some unknown period. Does this mean that the airline industry as we know it today is doomed to fail? I remain confident that this will not be the case, because the airlines that are in trouble are all working hard at what they must do to survive and eventually return as viable competitors. How quickly and to what extent they recover will depend largely on two factors; how much they are able to reduce their costs, and the recovery of travel demand.

Although the airlines that are struggling the most brought part of the problem on themselves, a great deal of what has happened, beginning with the September 11 terrorist attacks and now the Iraqi war, are events over which the airlines did not have any control. My biggest concern is not that the carriers will fail to make the changes that are necessary for their survival, but that the continuing weak demand will lead to the failure of a carrier or carriers that would be viable long-term competitors once past the current crisis. The enormous benefits brought about by deregulation over 25 years ago are the result of a competitive industry. While we must insist that individual airlines deal with problems they have allowed to materialize, it is important that competition be given a change to survive these critical times.

While my focus here today is the financial state of the airline industry, this painful process affects everyone in the industry: Aircraft lessors and investors, aviation vendors, airports and their concessionaries, and – more than anyone else – airline employees. Since September 11, more than 100,000 airline employees have lost their jobs. Just in the past two weeks airlines have announced an additional 10,000 layoffs.

So I want to take a moment to say a special word about the men and women who staff our nation's airlines, who devote themselves every day to getting airline passengers where they want to go safely and efficiently. They are the essential ingredient in this great industry. It is they, when all is said and done, who will determine the future of their companies – mot merely by the financial sacrifices that many will have made, but by the way they do their jobs.

Not many people noticed that we had zero fatalities in commercial aviation last year. A statistic like that done not come about by chance. Of course, our superb FAA air traffic controllers deserve an important share of the credit for that performance. But it is also eloquent testimony to the care and competence that airline employees bring to the job every day. At a time like this, with the industry challenged in so many ways, is also reflects a remarkable level of integrity. They deserve much greater recognition for their exemplary performance, particularly at a time like this.

The aircraft industry has also been hard hit. Of the **X,XXX** jet aircraft available for service today, **X,XXX** are sitting on the ground, and in recent days the airlines have announced that dozens more are being grounded.

Finally, Let me shift gears a bit and talk about infrastructure. One of the most dangerous things about a market as soft as the one we're in at the moment is that it can create the illusion of adequate capacity. When resources are scarce, the temptation to take a respite from expansion can be hard to resist. But resist we must.

We are going to get through this. My personal conviction is that when we do, the industry will look a lot like the industry we have today, except that it will be more cost-effective, more competitive, and more robust. Maybe it's hard to remember after all we've been through, but the summer of 2000 was characterized by the worst delay and congestion we had ever seen. If we don't keep faith with our obligation to grow the system, there is no question that – sooner than you expect – we will again experience levels of congestion that call into question the ability of the industry to serve our economy.

Secretary Mineta is determined not to make that mistake. As many of you know, the Administration will very shortly unveil its proposals for the reauthorization of AIR-21, which expires at the end of this fiscal year. A lot of people at FAA and in the Office of the Secretary have spent a lot of time over the past several months developing those proposals, and we are proud of them. They will promote the industry's growth and vitality while retaining safety as our top priority. We plan to reinforce our commitment to safety by making substantial investments in National Airspace System infrastructure and ensuring that our highly trained controller workforce is fully capable of sustaining its high levels of performance over the course of the next reauthorization period and beyond.

Our proposal will also ensure that we are prepared for the demand levels predicted in the FAA's forecast earlier this week by continuing to fund airport capacity enhancements at record levels and modernizing the Airport Improvement Program. We will do all of this while continuing our quest to enhance competition at airports throughout the country.

Conclusion

Mr. Chairman and members of the Committee, thank you for the opportunity to testify here today. I look forward to responding to any questions you may have.